

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
MADERA DEVELOPMENT CO. }

Appearances:

For Appellant: Wiley Y. Thompson  
Attorney at Law

For Respondent : John D. Schell  
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Madera Development co. against a proposed assessment of additional franchise tax in the amount of \$5,952.32 for the income year ended January 31, 1966.

Appellant is a California corporation, It was incorporated in 1957 and, until January 27, 1967, was actively engaged in the business of subdividing and selling land near Fresno, California. Appellant adopted a fiscal year ending January 31, and it elected the installment method of reporting the income from its land sales. On June 10, 1966, appellant filed with the Secretary of State a certificate of election to wind up and dissolve. However, although appellant distributed its assets to its shareholders and ceased operations on January 27, 1967, no certificate of dissolution had been filed with the Secretary of State as of the date we heard this appeal.

On January 31, 1966, appellant owned installment obligations representing \$114,435.57 in deferred, unreported installment income. During the fiscal year ended January 31, 1967, appellant collected \$60,294.82 of this income and reported it on its franchise tax

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return for that year. The other \$54,140.75 was part of \$80,357.59 in principal amount of installment obligations distributed to appellant's shareholders on January 27, 1967. Appellant treated this uncollected income of \$54,140.75 as gain resulting from the distribution and, pursuant to Revenue and Taxation Code section 24670, <sup>1/</sup> it reported this sum in its return for the year ended January 31, 1967. Thus, the entire \$114,435.57 was reported on appellant's return for the income year ended January 31, 1967.

After auditing appellant's returns, respondent determined that appellant had ceased to be subject to the tax measured by net income during the year ended January 31, 1967, and that the \$114,435.37 should have been included in appellant's income for the income year ended January 31, 1966. The basis for this determination was Revenue and Taxation Code section 24672, which provides, in pertinent part, as follows:

(a) Where a taxpayer elects to report income arising from the sale or other disposition of property...[on the installment method], and the entire income therefrom has not been reported prior to the year that the taxpayer ceases to be subject to the tax measured by net income..., the unreported income shall be included in the measure of the tax for the last year in which the taxpayer is subject to the tax measured by net income.....

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1/ 24670. Gain or loss on disposition of installment obligations, (a) If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and--

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(2) The fair market value of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange.

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(b) The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

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Appellant protested this determination and takes this appeal from respondent's denial of its protest.,

Appellant's initial contention is that section 24672 is not applicable because appellant did not cease to be subject to the franchise tax measured by net income until the fiscal year ended January 31, 1968, and all outstanding installment income had been reported prior to that year. The theory is that appellant was doing business in California during the entire fiscal year ended January 31, 1967, was therefore subject to the tax measured by net income during that year (Rev. & Tax. Code, § 23151), and did not "cease" to be subject to that tax until appellant became inactive in the year ended January 31, 1968.

We have encountered this same argument on at least two previous occasions, (Appeal of American Home Supply, Inc., Cal. St. Bd. of Equal., May 19, 1954; Appeal of Leo J. Shanahan & Sons, Inc., Cal. St. Bd. of Equal., March 19, 1963.) In both those cases, we held that the year in which a taxpayer "ceases to be subject to the tax measured by net income," within the meaning of section 24672, is the last year in which that taxpayer's franchise tax liability is measured by net income. That principle governs the present appeal. Appellant concedes that the year ended January 31, 1967, was the last year in which its tax was measured by net income. Since the entire income from appellant's installment sales was not reported prior to that year, section 24672 applies and requires that the "unreported income" be included in the measure of the tax for that year. Under section 23151 or the Revenue and Taxation Code, the "measure of the tax" for the year ended January 31, 1967, is appellant's income for the year ended January 31, 1966. Consequently, the "unreported income" must be included in the computation of appellant's income for the year ended January 31, 1966..

Having determined that section 24672 does apply to the facts of this case, we now turn to appellant's alternative argument that respondent has improperly computed the amount of "unreported income" for purposes of section 24672. Respondent's position, embodied in the assessment at issue, is that the amount of unreported income is \$114,435.<sup>57</sup> the amount of installment income which had not been reported on or before January 31, 1966. Relying on prior decisions of this board holding that section 24670 must be taken into consideration in determining the amount of "unreported income" within the

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meaning of section 24672, (Appeal of Contractors Investment Co., Inc., Cal. St. Bd. of Equal., Jan. 5, 1961; Appeal of Pioneer Development Co., Inc., Cal. St. Bd. of Equal., Jan. 5, 1961; Appeals of Edside Bldg. Co., et al., Cal. St. Bd. of Equal.', appellant contends that, as to the installment obligations distributed to its shareholders on January 27, 1967, the amount of "unreported income" should be measured by the difference between appellant's basis in them and their fair market value on that date; And that value, says appellant, was substantially less than the face value of the obligations,

The proper resolution of this issue requires that the \$114,435.57 in allegedly "unreported income" be broken down into its component parts, for only in this way can the relationship between sections 24670 and 24672 be made clear. The component parts consist of the \$60,294.82 of income that appellant collected during the fiscal year ended January 31, 1967, and the remaining \$54,140.75 that had not been collected at the time of the distribution on January 27, 1967. As to the \$60,294.82, we hold that section 24672 applies and section 24670 does *not*, for the following reasons. \$51,930.93 of this amount was collected on installment obligations that were completely paid off by the debtors prior to the distribution of appellant's assets. Since these paid-up obligations were not "distributed" on January 27, 1967, section 24670 by its own terms does not apply to them. Consequently, section 24672 operates alone and requires that this \$51,930.93 of unreported income be included in appellant's income for the year ended January 31, 1966. The other \$8,363.89 of collected income was collected on the obligations that were distributed on January 27, 1967. This income did not arise from the distribution itself and seemingly would not be taxed under section 24670 because the fair market value of the obligations would be reduced by the amount of any collections on the principal prior to the distribution. Section 24672 must apply to this income, however, since otherwise it would forever escape the franchise tax, contrary to the very purpose of section 24672. We have never held that gain on the distribution of installment obligations, as computed in accordance with section 24670, is the only amount of "unreported income" which section 24672 requires to be included in the measure of the tax for the year of the distribution.

The \$54,140.75 of uncollected income stands on different footing. Under our previous decisions, this would be the amount of gain resulting from the distribution of the obligations, as computed under section 24670 on the

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assumption that the fair market value of the obligations on the date of distribution equalled their face value , and it would be "unreported income" within the meaning of section 24672. As we indicated earlier, however, appellant has contested respondent ' s determination that the obligations were in fact worth their face value on January 27, 1967. At the hearing appellant introduced the sworn affidavits of two independent appraisers who had made retroactive appraisals of the value of the distributed obligations. <sup>2/</sup> Taken together, those affidavits establish to our satisfaction that the fair market value of the obligations on January 27, 1967, did not exceed 50 percent of their face value (\$80,357.59), or \$40,178.80. In keeping with our prior decisions, the additional assessment must be reduced accordingly.

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<sup>2/</sup> In its post-hearing memorandum, respondent did not question the expert qualifications of the two appraisers. Instead, it argued for the first time that if sections 24670 and 24672 are to be construed together , as we have consistently held, then the pertinent date for valuing the obligations is January 31, 1966, rather than January 27, 1967, the date of the distribution. Since this construction of the two statutes could not be adopted without doing violence to the clear and explicit wording of section 24670, we cannot agree with it.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Madera Development Co. against a proposed assessment of additional franchise tax in the amount of \$5,952.32 for the income year ended January 31, 1966, be and the same is hereby modified to reflect our determination that the fair market value of the distributed obligations was \$40,178.80. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 11th day  
of May, 1972, by the State Board of Equalization.

John W. Lynch, Chairman

Robert J. [unclear], Member

Robert [unclear], Member

William [unclear], Member

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ATTEST W. W. [unclear], Secretary